NO. 2569

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

HOWARD D. THOMAS COMPANY, a Corporation,
Petitioner,

v.

WM. H. BEHARRELL, WM. C. ALVORD, and ELLIOTT CORBETT, as Trustees in Bankruptcy of the Estate of I. Gevurtz & Sons, Bankrupt,
Respondents.

In the Matter of I. GEVURTZ & SONS, Bankrupt.

PETITIONER'S BRIEF ON PETITION FOR REVISION.

Under Section 24b of the Bankruptcy Act of Congress, Approved July 1, 1898, to Revise, in Matter of Law, a Certain Order of the United States District Court for the District of Oregon.

MESSRS. BEACH, SIMON & NELSON,
Attorneys for Petitioner.

MESSRS. REED & BELL,
Attorneys for Respondents.

BOYER PRINTING COMPANY, PORTLAND, OREGON

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Petition for Revision of the Order Refusing Howard D. Thomas Company Permission to Liquidate Claim.

STATEMENT OF FACTS

Inasmuch as in this proceeding the Circuit Court of Appeals is asked to review not the Findings of Fact, but the *Conclusions* from those Findings, it will perhaps be most conducive to clarity if we adopt the Statement of Facts as made by the Referee, and ratified by the United States District Court for the District of Oregon, omitting opinions and conclusions of the Referee.

> "In April, 1913, the bankrupt applied to the Petitioner for the purchase of a lot of rugs, invoice of which was upwards of $3,000. At the time this order was given and the sale made the bankrupt was in difficulties with its creditors, was heavily involved and far in arrears with current merchandise bills. Negotiations had theretofore been had, and were at the time pending, with the First National Bank for securing funds sufficient in amount to take up and discharge all outstanding small merchandise bills, thus enabling the bankrupt to continue its business without being hampered. Probably at the suggestion of the bank, an expert accountant was then in the bankrupt's store engaged in making a technical estimate of its assets and liabilities, and a committee of three financiers, whether working under the direction of the bank does not appear, was acting in an advisory capacity with the bankrupt's officers. Two of this committee were prominent officers in the First National Bank and heavily interested in that institution. These negotiations had progressed far enough, as, I believe, to induce the officers of the bankrupt genuinely to believe that the bank intended to, and would, in a very short time, supply it with $100,-

000.00, or so much thereof as was necessary to discharge its *current* merchandise *obligations*. Indeed, I believe some money had already been advanced for this purpose.

In this situation, Philip Gevurtz, President of the Bankrupt, called Howard D. Thomas, President of the Petitioner, over the 'phone at Seattle and placed the order for the rugs in question. In this conversation Thomas at first declined to honor his order, telling Gevurtz that his firm was slow in paying bills, that they had failed to pay bills long past due, and that he would not ship the goods unless absolutely certain that Thomas & Company would receive its money. To this Gevurtz replied, in substance, that they were absolutely certain of paying the bill because they *had made* arrangements with the First National Bank to advance them $100,000. for the purpose of paying their pressing obligations, which would supply them with sufficient capital to run the institution along. He undertook to absolutely guarantee that Thomas & Company would be paid, and with this assurance Thomas agreed to ship the goods.

Within about thirty days from the date of the shipment negotiations with the bank, for some reason, *fell through* and bankruptcy was precipitated. Within four or five days before the petition was filed, Philip Gevurtz called Thomas & Company up on the 'phone and explained to them that they were in trouble and wished to return the rugs. Mr. Thomas, who is the manager and sole owner of the company, was absent in the East at the time and those in charge in his absence told Gevurtz they had no authority to re-

ceive the rugs back and that if they were shipped it must be upon the responsibility of Gevurtz & Company. However, their traveling salesman came down to confer with the bankrupt and, while here, this party was informed by Philip Gevurtz of the reason for wishing to return the rugs, which was that they were in serious financial straits, threatened with bankruptcy, and he felt in honor bound, in view of his statements to Thomas, to protect him. This party declined to receive the rugs upon the ground that he had no authority to do so, but anyway, the rugs undisposed of were at once crated and shipped back to Thomas & Company and credit was given by them to the bankrupt for the invoice thereof upon the account.

The petition in bankruptcy was filed early in May, 1913, and in September, 1913, Thomas & Company filed a claim against the estate for $996.26, the balance due upon the purchase price of the rugs after crediting the amount returned. Thereafter objection to the claim was made by the Trustees upon the ground that Thomas & Company had received a voidable preference through the return of the rugs, which preference must be returned to the trustees before allowance of a claim for the balance. On this objection being made Thomas & Company asked leave, before the Referee, to withdraw their claim, and, in support thereof, urged they were not advised of the alleged fraudulent representation made by Philip Gevurtz at the time of the sale. They were allowed to withdraw their claim. Subsequently they filed this petition to be allowed to liquidate their claim." (Re-

port of Special Master, Petition for Revision, pages 7-10.)

The Master as Conclusions of Law from said Findings decided that there was no fraud or mis-statement of facts sufficient to give petitioner the right to rescind the sale and reclaim the goods, and that even though such right to rescind existed it had been lost, because the petitioner in filing its claim before the Referee for the amount of the shipment had elected between remedies, and could not change its position.

To these Conclusions the Petitioner excepted, but its exceptions were overruled by the District Court, and this Petition for Revision was then filed in this court.

ASSIGNMENTS OF ERROR

1. That the Master and the Court having found as a matter of fact that the shipment of goods by Howard D. Thomas Company, had been induced by a mis-statement of material fact, made as of his own knowledge by the President of the bankrupt concern, who was in a position to know its truth or falsity, and that the statement was believed by and relied on by Howard D. Thomas Company to its damage, should have concluded *as a matter of law* that Howard D. Thomas Company had the right to rescind.

2. That the Master and the Court should have concluded *as a matter of law* from the facts found, that, inasmuch as the so-called election was not made with full knowledge of the facts, and no change of position had occurred and no interests of third parties had intervened, no principle of estoppel was involved and no

technical doctrine of election should be held to bar petitioner in this proceeding; that the conclusion that the principle of election should be invoked not only where the party has actual knowledge, but where he can be charged with knowledge which diligence would have enabled him to obtain, is erroneous and inequitable.

ARGUMENT

The argument in this case falls naturally into two distinct subdivisions, involving respectively the discussion of the two questions presented in the Assignments of Error, viz.:

I. Do the facts found by the Special Master justify a rescission by the Howard D. Thomas Company of the sale of rugs to the bankrupt?

II. Has the right to rescind been lost by a final election on the part of the Howard D. Thomas Company to ratify the sale?

I.

THE RIGHT TO RESCIND

The right of a creditor to reclaim goods in bankruptcy will be found, if analyzed, to be grounded upon the cardinal principle of the law of contracts, that a contract involves a meeting of minds upon the subject-matter. From that elementary principle arises the corollary that where the participation of one party to a contract is induced by the fraud or mis-statement of the other as to a material matter, the contract is voidable by the party defrauded, or misled. This right to rescind and reclaim is not altered or diminished by

ensuing bankruptcy; the courts, State and Federal, are all agreed upon that proposition.

It is important to discern at the outset just what was the Special Master's theory of the extent and limitations of this right to rescind. If his theory is erroneous, it is not surprising that his Conclusions from the facts in the instant case are erroneous. (We speak throughout of the Master's Report because the District Judge merely affirmed the report without opinion or specific reason and presumably adopted the Master's views.)

We call the Court's attention first, to the fact that there are two classes of cases with which the Federal Courts have been called upon to deal with regard to the right of reclamation. In one class the right is based upon the claim of the creditor that he was induced to part with the goods upon the faith of a false statement of a material fact. In the other, the claim to the right has been based upon the general proposition that the bankrupt at the time of making the purchase was insolvent, knew he was insolvent, and had no intention to pay for the goods.

The Petitioner in this case comes within the first category—*it rested its right to reclaim upon a particular false statement of material fact.* It has nowhere, and at no time attempted to rest it upon the doctrine of the second class of cases. The Special Master, however, in reaching his Conclusions of Law ignores this important fact, and apparently deduces his Conclusions upon the theory that the Petitioner's claim is under the second classification.

The Special Master points out in his Conclusions on this phase that "such a proceeding" (referring to

reclamation for fraud) "is not favored, etc." In this the Special Master is completely at variance with every authority to which we have had access. It is quite true that where the right to reclaim is based upon the theory of general statements of the bankrupt as to his solvency, or, upon the theory that the bankrupt was so grossly insolvent that he must have intended to commit fraud, the courts have been reluctant to sustain reclamation, because of the injustice that might result to other creditors, but nowhere, at no time and in no place has any court, insofar as we have been able to discover, indicated any reluctance to relieve a creditor from a contract *induced* and based *upon a clear mis-statement of material fact.*

That the Special Master reached his Conclusion upon a theory not advanced by the Thomas Company is apparent from his decision which was adopted by the Bankrupt Court.

> "In order to be allowed to liquidate its claim, the result of the transaction must be such as to create the right in the Thomas Company to rescind this sale for fraud and reclaim the goods. *Such a proceeding is not favored, and, to support it, the proof must be clear, either that the bankrupt falsely represented solvency when in fact he was insolvent, or, being solvent, falsely represented the extent of its assets, in each case for the purpose of obtaining credit. In this case there does not appear to have been any representation as to solvency.* The representation, such as was made, was rather as to the bankrupt's ability to pay. This might be construed to involve a representation as to the extent of the assets, but, if so, I think there is no question but

> that Philip Gevurtz stated conditions frankly and believed, and had reasonable expectations, that the bankrupt would be able to pay for these goods. Under these conditions, as I understand it, the right to rescind does not exist." (Special Master's Report, Petition, page 10.)

It will be noted that at the time at which the bankrupt ordered the rugs from the Howard D. Thomas Co. (some three weeks before the adjudication) the bankrupt was in difficulties and was operating under the guidance of a committee of creditors. It was manifest that no sane creditor would have extended credit under such circumstances in the absence of some special consideration. The special consideration as alleged in the Thomas Company's petition for reclamation, upon which it parted with its goods was the assurance of Philip Gevurtz, President of the bankrupt concern, that the First National Bank of Portland, *had agreed* to advance the sum of one hundred thousand dollars, with which to pay outstanding bills and *meet current obligations. This representation was false.* The Thomas Company parted with its goods, believing it to be true. There was no meeting of minds. We therefore contend that the Thomas Company had a right to rescind the contract and to reclaim its goods.

The Special Master found, as a fact, that Thomas, knowing something of Gevurtz's condition, was unwilling to make the arrangement. He also found as a fact that Gevurtz told Thomas not that he was "practically certain" of making arrangements with the First National Bank for the advance of $100,000.00, but that he "had made" such arrangements. (Special Master's Report, Petition, p. 8.)

The Special Master next found that "Within about thirty days from the date of the shipment negotiations with the bank, for some reason, *fell through* and bankruptcy was precipitated." This is equivalent, of course, to finding that the arrangements had *not* been made as Gevurtz stated, but that negotiations for same were in progress, which is a vitally different proposition. The Special Master, however, interlards his opinion that Gevurtz was acting in good faith, and believed the negotiations were "practically certain" to result as contemplated, and that he found no evidence of fraud or bad faith in Gevurtz's conduct. In this the Special Master is mixing law and fact. We maintain that when a man declares to be true a certain statement within his knowledge, and this statement is material and is false, the declaration is tantamount to a fraud on the party acting upon the faith of the statement, even though the declarant may in good faith believe that *thereafter,* at *some future time,* the facts stated to be existing, will *eventuate.* The maxim is still true that "there is many a slip 'twixt the cup and the lip."

Here was Gevurtz's concern on the eve of bankruptcy, heavily involved, and being steered by a committee of creditors. Application is made by it for a large shipment of rugs. The creditor naturally looks with disfavor upon the order, but is assured that through an arrangement which has been *perfected,* a powerful bank is advancing $100,000. with which to pay *current bills,* and on the faith of that statement the shipment is made. Three weeks later the doors of the concern are closed, and it develops that no such arrangement had been perfected. The creditor who if the arrangement had really been perfected, would have received 100 cents on the

dollar for the "current obligation," is now asked to take twenty-five cents. Can this be called "good faith," in logic, morals or law?

The Special Master, we submit, viewed the transaction solely from the attitude of the bankrupt, whereas the creditor is also entitled to consideration. The Special Master solved the question against the creditor *because the bankrupt did not in his opinion actually intend to cheat the creditor.* He overlooks entirely the fact that the creditor was cheated; that the creditor is interested in facts, in conditions, in results, not in motives. The Thomas Company was just as much mulcted, created and defrauded when it relied, as it had a right to rely, upon the express statement of material fact, even though made with no intent to defraud, as though it were made pursuance of an evil design. It is small comfort to the Thomas Co. to tell it, "Yes, the President of the bankrupt concern made you an assurance of material fact, which really was not true. You had a right to rely on it. You did rely on it, and you delivered the goods. They were secured from you by a false pretense, but the man who secured them did not intend to cheat you, therefore, be satisfied." We do not believe that the authorities sustain any such absolution or sanctification of what is, at least, fraud in a legal sense, by unctuous protestations of absence of intent to defraud. The matter must be viewed *objectively,* as well as subjectively, and objectively, *conduct* is more important than *motive.*

Waiving, therefore, the consideration that the Special Master in his Conclusions of Law apparently considered principally the question of *solvency,* and to a great extent eliminated the important allegation as to the false

statement, and taking his Finding of Fact that Gevurtz made the representation that his concern *had made* the arrangements with the bank, and that as a matter of fact they had *not* been perfected, but Gevurtz honestly believed they would be consummated, in connection with his *conclusion* that Gevurtz did not intend to defraud, it is apparent that the Special Master evidently believed that criminal fraud is a prerequisite to rescission. The District Court confirmed the Master's position, and we therefore ask the Circuit Court of Appeals to decide on this phase squarely between the position, and the position which we took below, which position, briefly expressed, is as follows:

> *Where a contract is induced by a statement of material fact made as of his own knowledge by one in position to know its truth or falsity, and the statement is believed and relied on by an innocent party to his damage, and is not true, the transaction is fraudulent as a matter of law, and the innocent party may rescind.*

The Special Master to sustain his position in this regard cites three cases (Special Master's Report, Petition, page 10):

In re Burk, 25 Am. B. R. 170;

In re Roalswick, 110 Fed. 639;

In re Davis, 112 Fed. 294.

In the *Berg* case, 25 Am. B. R. 170 (erroneously cited by the Master as in re Burk), the creditor's claim was based upon a statement of assets and liabilities made by the debtor a year and a half before the order was placed. As a matter of fact this statement was substantially true. The creditor's position was based upon

what we have called the second classification, that is the *general intention* on the part of the debtor not to pay his bills. The District Judge affirming the Referee said concerning the bankrupt:

> "If he really represented himself as better off in October, 1909, than in December, 1908, *it would make little difference whether he actually knew his own financial condition or not. Of course, he must be held to know what he undertook to represent.*"

In the *Roalswick* case, decided by the District Court for Montana in 1901, no direct representations were involved. The creditor claimed to have made his sale upon the report of a mercantile agency. There was *no* proof of *false* or fraudulent *statements.* The debtor continued in business more than six months after the order was placed. We have no quarrel whatsoever with the decision of the Court. Its position was clearly expressed in the following language:

> "There must be such representations or statements to the seller by the buyer, in relation to his commercial standing, financial condition, etc., from which it may reasonably be inferred that if the seller had known or been informed of the true state and condition of the buyer's affairs, he would not have consummated the sale by a delivery of the goods."

In the *Davis* case, also decided in 1901, by the District Court for the Southern District of New York, there was *no* proof of *false* representations of *fact,* or that the representations made had been relied on. The creditor claimed that a long time prior to the sale the

debtor had told him that he had assets of two for one as compared to his liabilities. The creditor admitted that he would probably have sold the debtor in the absence of this statement. It is apparent that this comes within what we have called heretofore the second category, dealing with *general statements* as to solvency and insolvency in which the proof must be very clear.

If these cases justify the Conclusion reached by the Referee, then we fail to understand the language of the opinions.

* * * * *

We shall not attempt any exhaustive citation of authorities, but we ask the Court's attention to a few of the decisions on the precise question:

In the case of Vaughn v. Smith, 34 Ore. 54, the Court said:

> "The defendant's *representations* with regard to the condition of the title to the premises being *false in fact,* though made, as the court finds, *'unthoughtedly,'* and being relied on and acted upon by the plaintiff constituted such *constructive fraud* as will authorize a court of equity to treat the deed as an executory contract to convey and *rescind* the same. * * * *Defendant's representations, therefore, however innocently made, afford no defense to the suit."* (Italics ours.)

In the matter of Underwood v. Daniel, 32 A. B. R. 779, the only question involved was whether it was necessary to show that the misleading statement was made with fraudulent intent. The Court answered it in the negative, citing with approval:

Newman v. Claflin Co., 107 Ga. 89, 32 S. E. 943:

> "When a vendee of personal property makes a material representation which is false, and upon which the vendee is induced to act to his injury by parting with the possession of his goods, such a misrepresentation amounts to a fraud in law which voids the sale and equity may rescind the sale and restore the parties to their original rights, *although the party making such misrepresentation was not aware that his statement was false.*" (Italics ours.)

And citing also:

Washburn v. Dannenberg, 117 Ga. 567, 44 S. E. 97:

The law is clearly and tersely laid down by Circuit Judge Hook in Ellett-Kendall Shoe Co. v. Ward, 26 A. B. R. 114; 178 Fed. 982:

> "The Referee fell into an error in holding that to constitute a fraud authorizing rescission of a sale, the financial statement by the bankrupt must have been made with intention not to pay. *The rule is broader.* True, when a purchaser buys with intent not to pay, the sale may be rescinded, *but it may also be rescinded regardless of his intent* about paying, if induced by his false and fraudulent representations."

We have heretofore shown that a careful analysis of the Master's Conclusion will disclose that his opinion is based on a fundamental misconception, and that is, *that the test is whether or not the bankrupt intended or expected to pay,* and whether bankrupt believed itself solvent or insolvent. The Master, apparently, holds

the view that the burden is on Thomas to show actual fraud to the extent of absence of any intent to pay.

We do not believe any reputable authority for such a postulate can be found. The Master, as we have suggested hereinbefore, confused this case with cases where the claim of rescission was based on general charges of fraud arising out of a condition of insolvency existing at the time of purchase. Our claim is not on this basis, but is grounded on a particular and specific false statement of a material matter, and here intention to pay and ignorance of insolvency are not decisive or even material considerations.

In Pier v. Doheny, 86 N. Y. Supp. 971, the Court reversed a referee who had found that no intent to defraud existed, the court saying, after pointing out that the statement in question had been made for the purpose of obtaining credit and had been relied upon:

> "It follows, therefore, as a matter of course, that G. intended to deceive the plaintiff and thereby secure its property on credit, and such deceit resulted in damage to the plaintiff to the extent of the hops sold and delivered. That was a fraud upon the plaintiff *whether G. believed the property could be paid for or not; whether he intended it should be paid for or not. It was not necessary to find that the purchase was made with a design not to pay for the property in order to render the company liable.*" (Italics ours.)

And in Mills v. Brill, 94 N. Y. Supp. 163, the court held that where there was a false statement of financial condition, proof of intention to defraud was not necessary. The court held that when the plaintiff proved

the statement to be false and made for the purpose of obtaining credit, the intent to defraud follows as a necessary inference, saying on this point:

> "He may have expected to pay, but the liability was incurred *upon the basis* of a false statement, and the necessary result of his act was to cheat and defraud the plaintiff, *and therefore in law he must be held to have so intended.*" (Italics ours.)

In the case of In Re Hamilton, 117 Fed. Rep. 774, the precise question was passed upon, the Trustee appealing from the decision and resting his right of reversal on the contention that to entitle the petitioner to a rescission it was incumbent upon him to show that the purchase was made while the buyer was insolvent, with the pre-conceived design then present in his mind not to pay for the goods. The court thus answered this contention:

> "Where a sale of goods is induced by a false and fraudulent representation, *the intention to pay for them does not sanctify the fraud,* and the party defrauded is entitled to rescind *without regard to such intention.* In such a case of active and aggressive fraud, *the question, whether the wrong-doer intended to pay, is immaterial.* The Trustee holds the goods affected with the fraud of the bankrupt. *Neither law nor morals will justify the Trustee in holding goods obtained by fraud of the bankrupt, for the benefit of other creditors. Creditors have no right to profit by the fraud of the bankrupt to the wrong and injury of the party who has been deceived and defrauded.*" (Italics ours.)

The case of In Re Epstein, 109 Fed. Rep. 874, is also in point, Epstein having omitted certain indebtedness to his father and children from a statement, claiming that he did not consider them business debts. The referee found that *no fraudulent intent existed.* The Court reversed his findings, pointing out the precise distinction we have referred to, but which the Master entirely disregarded.

> "Had the intervenors relied solely upon the fact that the goods were obtained by the bankrupt *with fraudulent intent not to pay for them,* perhaps this contention would be correct; but as a rescission is also asked upon the ground that the goods were obtained upon the *misrepresentations* of the bankrupt, who concealed the fact of his indebtedness to his father and children, the question to be determined is whether such misrepresentations, *although not made in bad faith, nor with fraudulent intent,* are sufficient to entitle the vendor to a rescission. * * * * *In such case the intent is immaterial.* If a buyer knowingly makes false representations concerning material facts and thus induces the seller to part with his goods, the seller may elect to avoid the sale and this without regard to whether the buyer intended to pay for the goods or not. The fraud in such cases consists in statements by the buyer known to be false when made, or made by him when he has no reasonable grounds to believe that they are true. * * * That a sale induced by such false representations may be rescinded, although the purchaser made them with no fraudulent intent, is well settled."

Judge Lurton, in the case of In Re Sweeney, 168 Fed. 612; 21 A. B. R. 866, while denying rescission

because the vendor in that case knew the bankrupt's real condition and took the chances, held that the falsity of a financial statement makes a *prima facie* case for rescission.

In the case of Turner v. Ward, 154 U. S. 618, the United States Supreme Court held that rescission should be granted in a case in which it was conceded that the defendant did not know that he was insolvent when he made the misrepresentations. And to the same effect see:

In re Hamilton Furniture & Carpet Co., 117 Fed. 774,

In re Weil, 108 Fed. 987,

In re Davis, 112 Fed. 294.

In re O'Connor, 114 Fed. 777,

Bloomingdale v. Empire Rubber Co., 114 Fed. 1016,

In re Hildebrand, 120 Fed. 992.

It is apparent therefore that the rule is all but universal that misrepresentation of a material fact, relied upon by the other party, constitutes ground for rescission, the theory being that there was never a meeting of minds, and therefore the transaction was never really consummated. In other words, the contract is voidable by the party deceived. An assignee of the guilty party has, of course, no higher standing than his assignor, and the United States Supreme Court has held that this rule applies to a trustee in bankruptcy—Donaldson v. Farwell, 93 U. S. 631.

In view of the pronouncement of the Master that such a proceeding is not favored, we challenge the production of one case in which any court has declared

that it is against the policy of the administration of the bankruptcy laws to allow reclamation where it is based upon a specific false statement of material fact.

It is difficult to see how any court, especially one of equity, can hold any different view than that expressed in In re Hamilton, 117 Fed. 774:

> "Neither law nor morals will justify the Trustee in holding goods obtained by fraud of the bankrupt, for the benefit of other creditors. Creditors have no right to profit by the fraud of the bankrupt to the wrong and injury of the party who has been deceived and defrauded."

II.

WAS THERE A BINDING ELECTION, PREVENTING A RESCISSION?

The Special Master found as facts, that after the rugs had been shipped by the Thomas Company, and some few days prior to the adjudication in bankruptcy, Gevurtz called the Thomas Co. over the long distance telephone and expressed a desire to return the rugs. Thomas, the manager and sole owner of the Howard D. Thomas Company, was at this time in the East and the Thomas Company's office refused to authorize the return. However, a traveling salesman employed by the Thomas Company came to Portland and was told by Philip Gevurtz that the situation was desperate, but this salesman had no authority to, and declined to receive the rugs. Gevurtz, notwithstanding this, returned the Thomas & Co. those rugs which were on hand and a day or two later the adjudication occurred.

It will be noted that *there is no finding* that Thomas

& Co. had any *knowledge* at this time that the *statement* with reference to the $100,000. was *not correct.* It therefore had no knowledge of any facts justifying a rescission. Indeed, the necessary inference from the refusal on the part of the Thomas Co. to authorize the return of the goods is that the concern had no information as to the real situation with regard to the $100,000. It must be assumed in the absence of some strong reason to the contrary, that Thomas & Company, just as any other concern, would be governed primarily by self interest, and if it had known that the facts existed which permitted a rescission on its part, it is almost a necessary inference that it would have, as a commercial concern, *availed itself of this right.*

Thomas & Co. then filed its proof of claim in bankruptcy for the price of the rugs which had not been returned. There is no suggestion, direct or inferential, that at the time of filing this claim Thomas & Co. had learned of the falsity of Gevurtz's statement as to the advance of $100,000 by the bank.

The Trustee in bankruptcy filed objection to the claim on the ground that the receipt by Thomas & Co. of the returned rugs constituted a preference. A hearing took place on the objection to the claim, and as a result of the developments at that hearing Thomas & Co. filed a petition for leave to withdraw its proof of claim. The Referee in Bankruptcy *granted* this, and Thomas & Company thereafter filed its petition for leave to liquidate its claim, which petition is in effect, a petition for rescission or reclamation. It is this state of facts which the Referee concludes justifies, as a matter of law, a ruling that Thomas & Co. elected to ratify the sale.

The facts are eloquent: The bankrupt obtained four thousand dollars worth of goods from Thomas on the eve of bankruptcy; the goods were procured with the consent of a committee of creditors of long standing in order to keep the bankrupt's store open; they were procured by misleading Thomas and under circumstances which equity and good morals declare unconscionable. It seems a contradiction in terms to assert that an "equitable" doctrine of election should be invoked to perpetuate such a fraud.

The doctrine of election is useful and important, but equity will be reluctant to invoke it where it will work injustice and where there is no estoppel which calls for it. Certainly equity will insist that the election have been made with *full actual knowledge of the facts.* The Master concludes that Thomas should be charged with knowledge of all facts he *could have ascertained by inquiry.* This is true in some fields of law, but has *never* been so declared as to an *election* which is based on *volition, active, conscious choice between known remedies.*

In support of his ruling in this regard the Special Master cites as his authorities:

In re Droege v. Ahiens etc., Mfg. Co., 163 N. Y. 466;

In re Hildebrandt, 129 Fed. 992.

In the first of these cases, Droege v. Ahiens, the claim of reclamation was based upon the falsity of a statement purporting to show solvency of the bankrupt. This statement indicated a large surplus over liabilities, and a month after it was given to the creditor, the debtor made an assignment. It is apparent that the fact that the assignment followed upon the heels of the statement

showing an excellent financial condition, in itself brought to the creditor *knowledge* that the statement was not a true one. The creditor a few weeks after the assignment filed his proof of claim with the assignee. A month later he filed a mechanics lien on certain premises for material sold the debtor; a month after that time he was writing to ascertain the chances for a dividend, and some six months later, for the first time, notified the assignee that he had elected to rescind. The Court under this state of facts held that he had already elected to affirm the contract, that being the only construction which could be placed upon his filing his proof of claim, and later asserting a mechanics lien.

The court in deciding the case gave full recognition to the doctrine that in order to constitute an election, the *affirmation must be with knowledge of the essential facts.*

The distinction between that case and the instant case is obvious. Gevurtz's bankruptcy did not disprove his assertion that the $100,000 had been or was being advanced by the bank. Gevurtz owed at this time some several hundred thousand dollars, and the advance by the bank was, according to Gevurtz's statement, being made solely for the purpose of paying small claims and *current obligations,* i. e., of paying people like the Thomas Company, cash for the shipment ordered. Gevurtz's bankruptcy was not necessarily inconsistent with the truth of this statement as to the $100,000.00, and hence cannot be said to have brought to Thomas Co. knowledge of its falsity.

The other case cited, that of In re Hildebrandt, discloses that the court was extremely reluctant to hold an election had taken place, and so ruled because, as it dis-

tinctly pointed out, the creditor had *actual* knowledge of the conditions and in fact filed *simultaneously* two claims, one in *contract* for a portion of the funds, and the other in *tort* for the other portion!

Neither of these cases justifies the Special Master's position that Thomas must be held to have elected, not because he *knew* the representations of Gevurtz to have been false when he filed his proof of claim, but because he was in possession of such facts *"as to put him upon inquiry concerning the same."*

If "election" were a favorite doctrine with the courts there might be some basis for invoking it, not only where a creditor acts with knowledge, but where he has been put upon inquiry. Election, however, is based upon the principle of estoppel which has been declared to be odious to the courts. *If invoked in this case, it is invoked to validate and perpetuate a fraud and not to prevent one.* Surely the Court will not be alert and diligent toward such a consummation.

We submit that the doctrine is universally approved that where no rights of innocent third parties have intervened, and no change of possession has occurred, the party attempting to invoke the doctrine of election must *affirmatively* show the existence of the *knowledge* which is the fundamental consideration.

This is distinctly held in Russell v. Wilbur, 134 N. Y., pages 465-466:

> "While the plaintiff might have inserted a direct allegation in his complaint that at the time that he brought the first action he was not aware of the false and fraudulent representations that had been made to him—that is, that he was not aware that the representations made were

> false and fraudulent, still I think that the complaint can be fairly construed to state the fact, and the defendant, in order to show that the plaintiff knew it had two remedies, and elected one of them, must by an *answer* and *proof* show to the court that the plaintiff had such knowledge and did in fact make such election."

Prof. Redfield, in his article "Election of Remedies," 15 Cyc. page 261, tersely expresses the theory of election:

> "In order to constitute a binding election the party must at the time the election is alleged to have been made have knowledge of the facts from which the co-existing, inconsistent remedial rights arise."

Numerous citations are appended in a note in that volume. In that note occurs also the following illuminating passage:

> "Knowledge is not to be imputed as a matter of legal obligation, as the doctrine of election is not properly a rule of positive law, but a rule of practise in equity. In order that a person who is put to his election should be concluded by it, two things are necessary. First, a full knowledge of the nature of the inconsistent rights, and of the necessity of electing between them. Second, an intention to elect manifested, either expressly, or by acts which imply choice and acquiescence."

The Michigan court in Hogue v. Wells, 146 N. W. 369, says at page 370, discussing a case where plaintiff

had brought assumpsit and having learned the real facts, dismissed his action and filed one for trover:

> "It is well settled that a party cannot waive a right of which he has no knowledge. There can be no waiver unless the person against whom the waiver is claimed had full knowledge of his rights, and of facts which would enable him to take effectual action for the enforcement of such rights."

So, the Minnesota Court in the case of Kraise et al. v. Thompson, 14 N. W. 266, said:

> "A recission proceeds upon the theory that there has been a sale, but voidable at the option of the vendor on the ground of the fraud of the vendee, and that, having discovered this fraud, the vendor asks to avoid it. The invariable rule is that this right to rescind may be exercised upon discovery of the fraud and that no acts in recognition of the existence of the contract of sale, done before such discovery, will amount to an affirmance or ratification, so as to preclude the vendor from rescinding when the grounds for recission are discovered. Affirmance in ignorance of the facts authorizing recission will not prevent the affirming party from afterwards rescinding."

And the New York Court in Yarter v. Walcott, 145 N. Y. Supp. 132; 160 App. Div. 125:

> "The complaint alleges that the defendant for the purpose of inducing the plaintiff to enter into a contract for the sale of certain merchandise, and for the purpose of obtaining said merchandise,

represented to the plaintiff that he, the defendant, was then solvent and had on hand sufficient money to pay for the same; that the plaintiff, relying upon the representations and induced thereby parted with the merchandise to the defendant; that said statements were false, and were known by the defendant to be false, and that they were made for the purpose of deceiving and defrauding the plaintiff. Upon the trial the evidence was clearly sufficient to justify the jury in finding in favor of the plaintiff, and we are of the opinion that the fact that the plaintiff had previously secured a judgment against the defendant for the amount of the purchase price did not operate to an election of remedies. The facts in relation to the known insolvency of the defendant did not appear, and they were unknown to the plaintiff until the defendant's examination in a bankruptcy proceeding which followed the entry of the pltintiff's judgment in an action brought upon the original contract. Under such circumstances the plaintiff cannot be said to have elected between remedies. He merely pursued the remedy open to him under his contract, and when he found that the contract was founded in fraud he turned to his remedy for fraudulent representations, offering to cancel the judgment on contract; and this court is committed to the doctrine that this practice is lawful."

The leading English case on this subject is Clough v. London & N. W. Ry. Co., 7 Law Rep. 26 (Exchequer). The doctrine of that case has since been followed in England, and adopted in the courts of this country, State and Federal.

The Clough case points out that a contract induced by fraud is not void, but voidable; that where any step has been taken by the defrauded party, the question for decision is whether, with notice of the fraud, he has elected not to avoid the contract, or whether he has made any election. It was pointed out in that case that the mere fact that an action had been brought is not necessarily such a change of position as to preclude the exercise of the right to rescind, the only exception to this right being expressed as follows:

> "We think that so long as he has made no election he retains the right to determine it either way, subject to this: that if in the interval whilst deliberating, an innocent third party has acquired an interest in the property, or, if in consequence of his delay the position even of a wrongdoer is effected, it will preclude him from exercising his right to rescind."

There is no suggestion in this case of the intervention of the rights of any third party, or of any change of position on the part of the bankrupt, or of his trustee.

We invite the Court's especial attention to the full and scholarly opinions in two cases in which the facts are certainly much more nearly apposite to those in the instant case than are the facts in the In re Hildebrandt case, cited by the Special Master:

In the case of In re Stewart, 24 A. B. R. 474, 178 Fed. 463, the request to withdraw the claim, preliminary to rescission, was made nearly four months after it had been filed and nearly three months after admitted knowl-

edge of the facts, but the court disposed of the contention as to election in the following words:

> "It is true that when a person has two inconsistent remedies he may elect which he will pursue, and the election, once fully made, cannot be retracted. But an election of remedies presupposes knowledge of the two remedies, and, as between two causes of action, the one on contract and the other on fraud, a tort, the rule, presupposes a knowledge of the existence of the facts giving a right of action in tort for the fraud." * * * It is, of course, true that when Mitchell proved his claim he made himself a party to the bankruptcy proceedings, and he is now in this court seeking to establish a lien on the moneys of the bankrupt in bank at the time of the failure on the ground they include his money or deposits, and that the title is in him, and that he is entitled to an order directing the trustee to pay them over to him as the rightful owner. He claims that he has never made a legal election to pursue his remedy by proving his claim as a debt, for the reason he was ignorant of the facts and of his rights, and that his right to withdraw the claim proved is one of which the court cannot deprive him; that he has neither received a dividend nor done any act since informed of the facts which can be construed as a waiver of his right to stand on the fraud or as an election to stand on the claim presented and allowed; and that neither has been done by him at any time that in any way prejudices the rights of other creditors or that has misled them or the trustee.
>
> *I do not think it in accord with equity or good conscience to hold that a creditor*

of a bankrupt who has been in fact deprived of his property by the fraudulent acts of the bankrupt of which the creditor was ignorant, and who presents his claim as for goods sold and delivered at the first meeting of creditors, and then on a full examination of the bankrupt discovers the fraud, and that he is entitled both in law and equity to a return of his property, is estopped from withdrawing his claim as proved and allowed and proceeding to reclaim the property itself. I do not think it within the power of the court, or referee, to prevent such withdrawal or abandonment of the claim presented. The withdrawal is a matter of right in the creditor, and not a matter of discretion with the referee or judge. This is in accord with Standard Oil Co. of Ky. v. Hawkins, 74 Fed. 395, 20 C. C. A. 468, 33 L. R. A. 739, a case that has been frequently cited and approved. It was there held:

'When a party who has a choice of two remedies pursues one of them under the mistaken impression that the law affords him no other, and in ignorance of the existence of the other and more advantageous remedy, equity, in the absence of injury to others, or of facts creating an estoppel, may relieve him from the apparent election made under such mistake, and permit him to pursue the more advantageous remedy.'

The bankruptcy court is a court of equity and is guided, and controlled by equitable doctrines and principles. * * *

"As to laches, something over two months elapsed after discovery of the facts constituting the fraud before the claimant here took decisive steps to withdraw

his claim and take this proceeding. I hardly think this can be held laches. *Clearly no one was harmed; no one changed his position. The trustee did not distribute the estate, and neither he nor the creditors, or any one of them, has changed his position for the worse. Practically the matter stands where it did when the trustee was elected.* I regard it immaterial whether or not Mitchell took part in electing the trustee. His vote did not determine that question. It was necessary for Mr. Mitchell to consult counsel, examine the law, and prepare and serve notices and papers. I do not think the delay, under all the circumstances, was unreasonable. In equity cases it has been held that a delay of months, and even years, in some cases, is not such laches as will bar recovery or the equitable remedy." (Italics ours.)

Another thorough and instructive discussion is found in the opinion in Standard Oil v. Hawkins, 74 Fed. 395, 33 L. R. A. 739 (C. C. A. 7th Circuit), where it is said:

"The question is, therefore, whether, and under what circumstances, a party may be relieved from an ill-advised election of a remedy, when the election was made in ignorance that a better remedy was permitted by the law. It is one thing whether a contract will be reformed because entered into through ignorance and mistake of the law by one party, and quite another and different thing whether one may be relieved from an improvident election of a remedy occurring through his ignorance of possessing a better remedy. 'Election,' says Dyer, 'is the internal, free

and spontaneous separation of one thing from another, without compulsion, consisting in the mind and will.' (Bullock v. Burdett, 3 Dyer, 281). That designed selection cannot occur if the party be ignorant of his rights. *He cannot deliberately select one of two or more remedies if he know of but one to which he is entitled.* Therefore it is, as stated by Kerr, that 'an election made by a party under a mistake of facts, or a misconception as to his rights, is not binding in equity. *In order to constitute a valid election, the act must be done with a full knowledge of the circumstances of the case, and the right to which the person put to his election was entitled.*' Kerr, Fraud & Mistake (Am. Ed., notes by Bump), 453. Of course, the assertion by the appellant of a general claim against the bank was, in a sense, inconsistent with its assertion of right to pursue the proceeds of the drafts; and it cannot be allowed to shift its position, if the change would impose detriment, in a legal sense, upon the opposing party. It would then be estoppel, by its conduct. But if there be no estoppel, if no injury has resulted from the remedy pursued, to deny one the right to change position would be to say that a litigant must in the first instance, and at his peril, elect his remedy, and that he may thereafter pursue no other, although ignorance or misconception, he had failed to adopt, notwithstanding his opponent has suffered no detriment from the mistaken course pursued. We do not understand the law to justify so harsh a rule. If the appellant, in ignorance of its legal rights, believed that no other course was available than to prove its debt as general creditor; that it

> had no right, because of the fraud of the bank to retake from the receiver the proceeds of the paper tortiously obtained by the bank, the avails of which had come into possession of the receiver; and in such belief proved its claim as a general creditor —equity ought to permit the withdrawal of such claim, and the pursuit of an appropriate remedy, adequate under the circumstances, to restore its property, unless the action of the appellant has wrought a change in the position of affairs, working legal detriment that would render it inequitable for the appellant to pursue now a different course. We understand this to be the rule established, whether the mistake may be deemed a mistake of law or a mistake of fact." (Italics ours.)

The fiction of "election," as pointed out, is a useful one where third parties will be injured if change of position were permitted. *There is no pretense of any such condition in this case.* The court is aware of the fact that the average business concern has never heard the word "rescind," and that ordinarily in following its usual course of filing a proof of its claim in bankruptcy, it has no idea of deliberately choosing between known remedies. There is no finding of fact in this case that the Thomas Co. made any choice of remedies, or that it knew at the time of filing its claim that Gevurtz's statement with regard to the advance from the bank was false. The Master concludes as a matter of law from the facts which he finds that if Thomas Co. had made inquiries it could have found out that Gevurtz made a mis-statement. We have already discussed the fallacy of this observation, based as it is upon the misconception of the scope and purpose of the

theory of election. There is no element of estoppel in this case.

We can add nothing to the force of the strong decision in In re Stewart, supra, in which the facts with regard to the time at which the claim was withdrawn, etc., are unusually analogous. Nor do we believe that any infirmity can be found in the conclusion of Chief Justice Jenkins, expressed in Standard Oil v. Hawkins, supra, the language being also particularly applicable to the facts in the instant case.

On the authority of the reasoning of these two judges we ask that the Thomas Company be allowed to rescind, and share with other creditors of the estate to the extent of the damage which it has suffered, and that the Conclusions of the Special Master and of the District Court confirming them be reversed.

Respectfully submitted,

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